Replacing checklists with engagement

Presentation by Ryozo Himino, Vice Minister for International Affairs, Financial Services Agency, Japan, at Session I, Supervisory approaches for Oversight of Intermediaries, of the CFTC International Regulators Meeting, Boca Raton, Florida, March 13, 2018

Thank you, Chris [Giancarlo] and Eric [Pan] for your kind words. Good morning, everyone. Thank you all for giving me this opportunity to present the Japan FSA's plan to transform its supervisory approaches and to seek your comments and advice on it. But I suspect that some of you may be wondering what benefit you will have by discussing the Japanese supervisory approaches.

Japan as an economic policy laboratory

Indeed, it is widely considered that Japan mismanaged itself in late 1980s, in 1990s and in 2000s, was too-little-too-late in policy responses, and lost its once renowned competitiveness largely due to inability to change itself. What can one learn from that country?

But difficult problems Japan had to face during the last two decades led it to experiment many novel policy initiatives. For example, unconventional monetary policy measures, such as zero-interest rate policy, forward guidance and quantitative easing, were all first experimented with in Japan. Initially, they were considered as unique prescriptions to diseases unique to Japan, but as other advanced economies faced challenges similar to Japan's, those measures came to form a part of the standard toolkit of many central banks outside Japan, including the US Federal Reserve and the European Central Bank.

The JFSA's new supervisory approaches also include several unconventional elements. I hope you could look at it with open mind: They might be able to at least stimulate your thought.

This year, 2018, is the tenth anniversary of the global financial crisis. The enormous regulatory reform project during the last decade is now reaching its completion. The global regulatory community is now in a position to ask what's next.

The agenda for the next decade should include implementation of the agreed reforms, assessments of the effectiveness and the side effects of regulatory changes, and addressing new risks such as those arising from crypto assets and cyber-attacks. And, as Chris often emphasizes, addressing cross border inconsistencies is becoming more and more important.

In addition to these, I would like to suggest that we should look more at supervision. In my view, the last decade was characterized by too much optimism on the effectiveness of regulations and too much skepticism on supervision.

When dealing with general investors and issuers, we need to rely largely on regulations and enforcement. However, if we rely solely on regulation in our dealing with regulated entities, we are likely to overregulate, invite arbitrage, and miss the symptoms of the next crisis. We need to restore the role of supervision. In this respect as well, I hope the Japanese experiment on supervisory approaches could provide some food for thought.

The year 2018 is not just the tenth anniversary of the Global Financial Crisis. It is the twentieth anniversary of the Japanese Financial Crisis as well. Japan's problems were believed to have been due to deficiencies unique to Japan, but, after all, many other advanced economies also saw financial crisis and ensuing stagnation ten years later. Lessons from what happened in Japan's second "lost decade" may be useful in preventing the world to follow a similar path.

Japan has experienced twenty years of very low interest rates. It also has the fastest aging society in the world. These factors are changing the assumptions on which financial markets operate. I would argue that Japan is a front runner in facing the difficult challenges of the future.

FSA as Financial *Sanctions* Agency

So let's look at what has happened in Japan.

The JFSA was created twenty years ago amid an acute banking crisis. To end the crisis and resolve bad loan problems, the Agency conducted what we call special inspections. Our inspectors examined the classifications of individual loans, downgrading them from special mention to doubtful and from doubtful to loss. The operation was successful and the long hoped for financial stability was finally attained by around 2003, giving the new born agency much needed public trust and confidence.

This successful experience led the Agency to repeat asset quality review year after year. Bankers have become more and more risk averse, competing extremely hard for borrowers with strong balance sheets and good collaterals or guarantees. On the other hand, lending on borrowers' business prospects has come to be considered more risky, not necessarily because of probability of defaults, but because explaining borrowers' business prospects to inspectors is more difficult than showing collateral or guarantees.

A parallel process proceeded with regard to our conduct policy. In early years of the JFSA, there was strong social anger against multitudes of misconduct incidents by big banks, insurance companies and listed firms. In response, the JFSA issued 253 cease and desist orders in the peak year and, although the true name of the Agency is Financial *Services* Agency, it was often disparaged as Financial *Sanctions* Agency.

I believe that the "Sanctions Agency" contributed to enhancing internal controls at financial institutions. It also may have helped the Agency establish a public confidence that it is a friend of consumers, not of bankers.

But the repetition of compliance checks by the JFSA also had unintended consequences. When bankers meet customers, they have come to spend more time in creating evidence of compliance which can be shown to the JFSA inspectors rather than to identify customers' life plans and needs.

It is said that on one occasion one of the most respected economists in Japan visited a bank branch to buy a mutual fund and that the teller told him that at his age he had to be accompanied by one of his family members. The economist naturally protested but the teller only told him that they should follow the FSA's guidance.

This legendary era of the Sanctions Agency was even depicted in a television drama series, which was broadcasted on Sunday nights in the summer/autumn season of 2013. The viewer rating started from 20 percent and at the final episode reached 42.2 percent. You might think one could better spend Sunday nights doing something other than watching bankers and inspectors, but 40 percent of the Japanese families, or tens of millions of Japanese, did so.

The need for change

What could happen if we continue to apply the Sanctions Agency models? I think there can be three key risks.

First, the resources of the JFSA and bankers may be diverted from key priority issues to minor ones. It is much easier to identify minor misconducts than to discuss problems in culture, governance, risk management or business models. As banks' practices improve after repeated inspections, inspectors will be incentivized to split hairs more meticulously.

Second, although our approaches have been effective in cleaning up the mess after the crisis, they may not be effective in preventing future crises. Today, the yield curve is low and flat. Local communities are shrinking and disappearing in Japan. Traditional financial institutions will soon have to compete with Google, Amazon, Alibaba and other platform giants. Investors can be lured by virtual assets distributed by unregulated entities.

Policing misconducts and bad loans alone cannot address the problems to come in the future.

Third, many Japanese firms have developed extensive and detailed internal rules which correspond to each and every item of the JFSA's Inspection

Manuals. Whichever item in the checklist is questioned by inspectors, firms can readily show corresponding internal rules. And the implementation of those rules are meticulously documented and policed internally.

Suppose a banker takes an initiative to start a new project, process or product. She needs to persuade the firm to change a multitude of internal rules. The existing rules, however, survived repeated inspections by the JFSA. Some of the rules might have been introduced in response to the business improvement order issued by the JFSA fifteen years ago. Naturally, resistance to change can be strong. Innovation can be stifled.

JFSA's new approaches

To address these risks, the JFSA has redefined its regulatory goals, and plans to expand its perspectives, adopt approaches different from those of the Sanctions Agency days, and transform itself.

First, we have redefined our regulatory goals. In the past, we defined our goals as financial stability, consumer protection and market integrity. It was consistent with IOSCO objectives, which are investor protection; fair, efficient and transparent market; and reduction of systemic risk.

However, what we have seen during the last twenty years is that attaining the three objectives alone does not pull Japan out of the post-crisis stagnation. We included effective financial intermediation, better services, and market vigor in our basic goals, and defined our ultimate goal as maximizing national welfare by promoting sustainable growth of the economy and national wealth.

I know that this definition of regulatory goals is somewhat unconventional: the Basel Core Principles argues that financial stability should be the key goal and any other missions should be subordinated to it.

However, I have an impression that the series of U.S. Treasury reports published since last June are heading for a direction somewhat similar to ours. And the series of speeches by Chris, including the February one in New York, stand out in emphasizing market vigor and economic growth. Recent FSB

statements also make it clear that the ultimate objective is strong, sustainable and balanced growth.

Second, the JFSA intends to expand its supervisory perspectives. Our predecessor, the Ministry of Finance of Japan, was criticized that it misused its discretionary power and allowed forbearance. At its onset, the JFSA tried not to repeat the same path of its predecessor by focusing on objective, rule-based, *ex post* compliance checks.

After upholding this doctrine for two decades, however, there emerged a tendency to look only at the form, the past and elements. We intend to expand our perspectives to the substance, the future and the holistic analysis. The UK PRA advocates forward-looking, judgment-based approaches and I imagine that there may be some commonalities between the directions which the UK and Japanese agencies pursue.

Third, our new supervisory approaches will be composed of three pillars: enforcement; dynamic supervision; and disclosure and engagement.

The first pillar is enforcement. We will continue to enforce our rules but the emphasis will be on the overall effectiveness of firms' compliance system and governance, and we will try to address root causes, not just specific incidents.

The second pillar is dynamic supervision. We will put our emphasis on forward-looking analysis and shift from periodic on-site inspection to continuous and seamless monitoring.

The third pillar is disclosure and engagement. We will promote disclosure and engage with firms to support the pursuit of best practices.

Fourth, in order to make such changes possible, we will transform the JFSA itself. Shifting supervisory focus to the substance, the future and holistic analysis requires more exercise of judgments, and thus could be accompanied by the risk of arbitrary, inconsistent, subjective exercise of regulatory power. To mitigate the risk, we will enhance our own governance, internal quality control and make more effective use of feedback from outside the Agency.

We also intend to repeal the Inspection Manuals, or the checklist for inspectors, in April 2019 or after. Even after the repeal, the existing five thousand pages of laws, regulations and supervisory guidelines will stay. In addition, they will be supplemented by theme-specific discussion papers which clarify principles and approaches. But we will stop being prescriptive in specifying how firms should attain the goals set by laws and regulations.

We also intend to change our organizational structure, our human resource policies, training programs, and IT infrastructure.

We have just completed sixty roundtable discussions on our new approaches in eleven cities in Japan, with financial institutions, audit firms and JFSA local office staff. We intend to publish several discussion papers on more specific approaches, go forward with internal changes, and, about one year from now, repeal the Inspection Manuals.

This is what we plan to do. I know this is not easy. The success critically depends on the transformation of the JFSA's own culture, governance, employee skills, and processes, which is already difficult enough. In addition, changes at the JFSA need to be matched by changes in financial institutions. If firms are not willing to use the new room for innovation but prefer to have JFSA prescribe what they should do, the benefit of the changes will not be attained.

We need support from users of financial services as well. If consumers, and also news media, insist on zero tolerance towards misconduct, it would become more difficult for bankers and regulators to adopt a risk-based approach.

I am very keen to learn if you have issues similar to those I have described, and, if so, how you deal with them. I would also appreciate it if you could identify weaknesses and problems in our planned approaches, because such will help us do the job better. So I very much look forward to today's discussion.

Thank you for your attention.